## Fidelity Connects

**Dividend Investing in the Second Half**

**Ramona Persaud,** Portfolio Manager

**Pamela Ritchie,** Host

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**Voiceover:** Hello and welcome to Fidelity Connects – the Fidelity Investments Canada podcast – connecting you to the world of investing and helping you stay ahead.

Today host Pamela Ritchie is joined by portfolio manager Ramona Persaud for a look at dividend investing in the second half of 2021.

For Canadian investors, Ramona has portfolio manager or sub-portfolio manager responsibilities on several Fidelity funds, including U.S. Dividend Fund, Global Monthly Income, Global Dividend and Tactical High Income.

Ramona shares how she is approaching her portfolios as we transition from early to mid cycle. But, Ramona notes that the framework of early/mid/late cycle hasn't been as clear lately as it's been historically. Ramona also reminds us that her colleague Denise Chisholm expanded on this in her recent show, so please check out that episode if you haven't already!

Also, Ramona, who last joined us for an interview on Earth Day, reflects on how ESG investing may factor into her portfolios. She'll also share where she is finding opportunities from a sector and regional perspective, and discusses the sustainability of dividend yields.

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**Pamela Ritchie:** Ramona, I think we spoke to you last on Earth Day, and there was an amazing focus and lots of feedback on some of the discussions we had about ESG. We'll go into those actually in a little while. But first of all, just to kind of get your sense of the temperature of the markets right now, what we are watching unfold, but really from your personal perspective as you manage and how you look at your portfolios. What does this moment mean to you?

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**Ramona Persaud:** It's a good way to start. I think you framed it really well in saying that potentially we're transitioning from what is typically called an early part of the market cycle to a more middish part of the market cycle. The only caveat is, and Denise's work has shown this, that that framework of sort of early, mid and late hasn't been working the last several years as it did historically. So loosely we can still maybe think about it, but we have to leave room for it not working completely the way it did historically. So potentially we're going into some kind of mid and usually in mid ... and

I think Jurrien might have touched on this yesterday with you … usually in mid, things are slowing down a little bit. They're no longer at this blistering recovery pace. The Fed, central banks in general, are starting to talk about less ease, less monetary ease, and not necessarily tightening but not as much easiness and the markets start to get a little bit nervous.

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What usually makes me really happy about this part of the market cycle is it becomes less about macro, so less about things like the ISM and interest rates, and it becomes much more stockpicking oriented. So the [distribution?] of stockpicking to total returns as a factor tends to be pretty good, and that's just fun as a bottom-up stock picker. So I'm excited for this phase.

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**Pamela Ritchie:** We've discussed in the past cyclicals. We've discussed defensive sides of the market. All of these fit, and I'll let you certainly tell us more about your style and your process. They fit with your style in their process, but they've also been what has worked lately. It's also been that kind of market. Does it still work based on some of the things you just said? But are we still at a moment where defensives look good to you, where sort of the cyclical trade is still on? How does that all fit in?

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**Ramona Persaud:** Yeah, good question about the trade that's been on since last fall and for much of the last 18 months. Are we still there? So, you know, with each passing day, we kind of got less and less there. If you look at March of 2020 as the trough of value, if you will, the peak of fear was March of 2020. And from that point on, value just had pretty good returns because the valuation of value, if you will, got to be so dislocated. As Canadian investors, you were probably more sensitized to this with that moment where technically oil prices went negative, oil and gas being such a deep value sector and this idea of negative pricing was just kind of crazy. So that's such a moment for indicating the cheapness of value. So from that point forward, value kept working.

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So your question is, do we have more? And as you all know, I tend to use valuation as my guide. All of valuation tells you today is valuation spreads, so that's my kind of go to metric. The differences in valuation relative to average differences, they're very compressed, certainly relative to March, relative to July and relative to [audio cuts out] of the year. They just kept compressing and compressing. That, to me, is an indication that it's a more balanced market. I think that's what I said the last time we spoke about active investing. It's not as obvious that it's a value trade. You see that from the top-down with valuation spreads; you also see it from the bottom-up.

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When I look at consumer discretionary, which I owned a lot of coming out of March last year and all throughout the year, so apparel and brick and mortar retailers and restaurants and restaurant supply companies, all the things that would benefit from coming out of the pandemic, the valuations are just not that compelling. So what I do own in, say, that sector, that economically sensitive sector, are things where I can still find compelling valuation, but it's a lot less names and name count than it was certainly a year ago, if that's an example of where we are.

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**Pamela Ritchie:** Does the regional view come into this? I mean, there are those that will say certain parts of a value trade, we can call it a lot of different things, but have worked very well perhaps in North America, that there is sort of versions of catch-up trades in Europe. How do you look at things regionally at this moment?

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**Ramona Persaud:** Good question. I like the way you're framing it, like for cyclicals versus defensives and can we get any edge by going regionally? So what I would say is just sort of going back to cyclicals, there's less opportunity in economically sensitive and a bit more opportunity in defensives. The way that we get there, and I'll get to regions in a minute, but the way that we get there is when you look at the valuation of defensive stuff versus the market or even defensive stuff versus cyclicals, it's just a much more interesting valuation. Valuation spreads within, say, consumer staples have widened out a lot. So that's my indication to go start hunting there. So I use valuation to figure out where it's essentially a target, what I call a target-rich environment, if we see ourselves as sort of hunters. So there's just a lot more in staples, health care, even utilities are more reasonably valued. So that's at the margin. That's where my incremental unit of capital has been going.

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As far as regionally, it's a somewhat different story. So the U.S. market is very much discounting emergence from pandemic, and that's because we are emerging from pandemic. The U.S. has done a pretty good job with vaccinations, et cetera. Even people in the areas that were especially afraid of the pandemic, those folks are out and about. The folks who were not as afraid of the pandemic were always out and about. So they're out and about even more now. The difference with the rest of the world is vaccine rollouts have been much more challenged, as you all know, in Canada and certainly in Europe where even today is July 7th, even through today in the UK, there's still all this consternation about where can people travel to? Do they have to have both vaccines? It made the headline that the chancellor of Germany yesterday said that visitors from the UK who were double vaccinated can enter Germany. Germany is great, but that's not exactly where you want to go in the summer.

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So there's still so much pandemic recovery yet to happen in the rest of the world, and you see it in the stocks. The stocks are hesitant. I can still buy, as of at least two days ago, I could still buy airport stocks in Europe, say, that were reasonably valued. I could still buy aerospace oriented. So things that are levered to a recovery in global travel, that space is still cheap ex the U.S. So the answer to your question is while in the U.S., I'm sort of skewing more defensively, there's still good valuation opportunity in cyclicals related to pandemic recovery outside of the U.S. because that recovery hasn't really happened yet outside of the US.

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**Pamela Ritchie:** Are previous levels of dividends sustainable through the future? I mean, there's probably a lot of different answers to that, but how do you view that?

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**Ramona Persaud:** Yeah, dividend sustainability is so important when running income- oriented strategy. So it's a good question. I probably feel at the margin better about dividend sustainability today than I did certainly going into 2020. That is because a lot of companies had to reduce or eliminate their dividends. And so payouts are a little bit ... and I

think Jurrien might have mentioned this yesterday … payouts are a little bit lower than they have been historically because we're in this cyclical place for payout ratios. So payouts are low and probably set to rebound as companies get their cash flow generation normalized post pandemic. So what that means for me is when payouts are low and set to rise and valuations are good, that is an awesome set up for alpha. I've mentioned that in lots of due diligences and lots of client events that we've had. If I can get a combination of low and rising payout in valuation, that's a great setup for stocks.

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I have that in many parts of the more economically sensitive areas. Financials, look at Wells Fargo. Wells Fargo has had a really tough, tough go of it. It's a cheap stock with a potentially improving payout ratio and its corporate governance is getting a lot better. So you can call that an improving ESG stock because the G part is getting a lot better and they're pretty keyed into the E and the S parts. I can check all these boxes with Wells Fargo in terms of dividend, where the dividend is cyclically and where it's going.

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**Pamela Ritchie:** It's interesting, some of the layers that you're just talking about, reopenings in different areas, but it's almost like there's a skepticism in the market a little bit. I wonder how you watch that play out. You've mentioned a few of the pieces there, but I just wonder if it creates extra opportunities, essentially, because perhaps there's a hesitancy in certain areas. Do you notice that?

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**Ramona Persaud:** Oh, man, I live for skepticism. That's the definition of a value investor, is somebody who sees opportunity where other people don't — not other people, but where the rest of the market doesn't. That's sort of what value investing is. The way that we often define it … this is not my framework, I'll just repeat it … we tend to define it in terms of apathy versus controversy. So apathy, when something else is the shiny new toy, if you will, in the market, so let's call that … not to pick on the growth people because the people who are really good at growth are really good at it and do really well for our clients … but the hyper growers in the market is like the shiny place, and so there has been, at times in the last 10 years there's been all this apathy about boring … as Joel Tillinghast likes to call it, about the mundane. We live for the predictable, stable, boring, mundane that gets cheap.

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So that's one type of value is apathy investing. At one point, P&C insurance, not exciting at all, P&C Insurance got really cheap because growth stocks were on a tear in the FAANG, in the height of the FAANG market, and P&C is like the staples of financials. So if I can get a really stable business with pretty decent returns and great dividend yields for a really cheap multiple, that's so exciting. So that's apathy. The other part of value is controversy. That's your skepticism. So we live for controversy. And when you've got over 120+ research analysts sitting all over the world, that's the way that you parse apart controversy. You take the market skepticism, and you try to figure out where the skepticism has it wrong.

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So an example, and it has yet to really play out, an example of one of the most hated stocks for the last few years is, again, Wells Fargo. Extremely cheap. I think in three or four of these webcasts ago, I cited the valuation difference between financial darling J.P. Morgan and financial villain Wells Fargo. That valuation spread was the widest it's ever been. It went all the way back to, like, I don't know, the '70s or something. So that's true controversy, true skepticism. When you get a stock that cheap, things can't get much worse. So, yes, there is some skepticism in the market. What I

love about investing is there's always skepticism somewhere that I can sort of use our research as a guided missile to figure out where the skepticism is right and where it's wrong and then go in the direction of where it's wrong and just wait. That's how you make money.

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**Pamela Ritchie:** I love that whole analogy, too. I imagine that COVID just provides another layer. It's sort of tough, probably, for all of us to meander our way through this moment. Does that translate for you, again, for opportunities?

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**Ramona Persaud:** The greatest example in a really long time was when energy prices technically went negative. If you're looking at your Bloomberg and it's going negative and you're like, whoa! Okay, what do I do with this? And to the extent that you've got strong analysts sort of telling you what's going on or you've got a background in deep cyclicals, in my case, it's in financials. I covered financials for a really long time all around the world, and I covered them through the global financial crisis, through the European sovereign crisis. When you've built that kind of fear tolerance into your stomach from having gone through these crazy moments in the market, you can deal with it happening again. So I think a lot of investing in controversy is having built a stomach, either through your formative zero to 20 years and/or your professional investing career, built a stomach for fear. I don't say that like you should. It's good if it's useful, it's not good if it doesn't serve you.

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So when we saw oil prices do what they did in March of last year, the stocks were so cheap. That's one of the most ultimate examples of investing through fear during the pandemic. What I'm trying to say about where we are today, there just isn't that much fear. There's some skepticism, but it's not like March of 2020. It's not like 2008. It's not like 2009, 2010 in Europe with the sovereign crisis. I think just building a stomach for fear, like the instinct, is very helpful as an investor.

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**Pamela Ritchie:** How does that help you ... let's go into ESG ... how does that help you ... to an extent, I think to a lot of investors, ESG is partially known but there's a lot to still flesh out. How do you walk through that again with confidence? Take us through a little bit your process for looking at stocks that fit what you're looking for and perhaps Fidelity also has a proprietary rating system, so you're using that, too. But this must take some bravery, too.

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**Ramona Persaud:** Yes. And I just want to say it's not being brave for the sake of it. You don't just go throw yourself into everything because then you'll blow up. It's really trying to take calculated risk and as I say, use the research resources as, I like to think of it as a guided missile to really figure out where to go. Many high-skepticism, high-controversy, high-fear situations I won't touch because I can't understand it. So I just want to put that up there. I'm not trying to advocate bravery for the sake of it. So in terms of ESG, it's a really good segue. I'm really happy that capital, or the market, is now interested in this topic because I do personally believe that capital should play a role in improving the world over time and not damaging it over time. But that can take a lot of different meaning. So I'm happy that this is now a focus, but we are still so early that the definition of what is ESG is still very, very wide. To me, though, that's the opportunity.

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So where capital has gone, or the market has gone, is into the obvious stuff, so solar and wind and EV batteries and things that are thought of as good for the environment, which by and large they are. But in terms of trying to link that for having an appetite for fear, where I think we ought to be looking next is the parts of the market that are so bad on ESG that the only thing they can do is improve. The market has given, say, tech a huge kind of ESG premium and has really punished, say, energy. So I like to call it the tech darlings versus energy villains and has a high degree of skepticism against energy, and for good reason. But at some point, that just is overdone in terms of valuation. When you look at the valuation of the biggest ESG names in ESG funds and you look at that valuation over time, so sort of the names in ESG funds, take that as a basket. So those names will change, so you let that basket change, and then you measure the valuation over time. That valuation is very peaky today.

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So in my mind, if I'm also trying to achieve alpha while trying to be ESG sensitive and again, my funds aren't ESG funds, but it's something that's personally important to me. If I also want alpha, I have to think about what's next, right? And if valuations are peaky, I have to go in the direction of, say, this idea of fear again. And that to me are parts of energy that might be getting better. So an example is, say, Suncor. It's cheap. So I always start with valuation, pretty good free cash flow yield, and it's getting better. So it's not great, the ESG scores are not great, but they're focused on it, they're sensitive to it, they're aware of it, and I like the fact that on the S dimensions, everyone thinks of energy companies on the E dimension. Oh, carbon, bad. Yes, it is bad. But if you're just trying to think about improvement, they seem to be concerned about, say, the Indigenous population, the effect of their business on that population, which stands out to me. So that's an example of sort of using this tolerance for fear and skepticism to go where the market might not be going yet.

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**Pamela Ritchie:** It's fascinating, honestly. So how, again, do these investments come within an ESG framework that's acceptable to you, and as you say, it's not an ESG fund, but that fit in the right way for you? Going forward, are dividends going to be hit by certain things like corporate taxes or hit by access to capital? How do you see some of the backdrop for the dividend picture on some of maybe the names you mentioned, but those industries as well?

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**Ramona Persaud:** So I just want to back up a little bit to talk about dividends at large, and then we can talk about going forward. So dividends are interesting. It was the primary form of capital return many decades ago. So think '60s, '70s, '80s, and because it was the only game in town in terms of return of cash flow but also in terms of generation of cash flow, those two went hand-in-hand. Those stocks dividend ... if you sort of study, and we've studied, which is why I'm going through this ... high-dividend yielding stocks did really well in those decades. And then the '90s came. Tax policy changed a little bit where it became good to do buybacks as well. So all of a sudden, if you will, return of capital in the form of dividend sort of lost share because it had full share to buybacks. You also see the efficacy of dividend yield as a factor start to go down in the '90s, 2000s, 2010s and then this decade as well.

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So dividend yield has become less of an alpha signal. I suspect it has to do with two things. One, you can now get your capital return in terms of buybacks. If you want some sort of return, you can get it in buybacks, so you would orient yourself towards companies that are buying back a lot of stock. Or two, the availability of free cash flow in the market is now much wider. It's not just from dividend-paying stocks, certainly in developed markets that have outsourced a lot of

their capital to emerging markets, their free cash flow went up a lot. So they're free cash flow margins went up a lot. So they were just generating tons of free cash flow, not necessarily giving it back in dividends, which means if you were after free cash flow in the '60s, '70s and '80s and you got it through dividends, you can now get it another way. So as a result, dividend yield as a factor, just isn't as strong as it used to be. That doesn't mean that there isn't a place for income-oriented investing. It does though give me conviction in also looking for alpha in my strategies. I'm not just looking for yield. Because yield alone has become a less good alpha factor. So I tend to balance my seeking alpha, if you will, with seeking yield.

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In terms of dividend going forward, the trick with balancing yield with alpha is valuation. So for me, the answer is sort of always valuation. So if I can find, to your question about what's going to happen to yield going forward and the other question about sustainability of yield, if I can find yield that's cheap or yield that's improving through a payout ratio and cheap, then the alpha odds go up a lot. So you'll notice in my portfolios, you won't necessarily get a fat dividend yield because often that will compromise the alpha, and I imagine you want alpha too as clients, right? Everybody wants the alpha. You will get a reasonable level of dividends because I'm always trying to get you through a full market cycle. I'm always trying to get you as much alpha as I can. So essentially, I'm trying to get total return with measured risk, which is essentially good Sharpe ratios, good information ratios, risk-adjusted return.

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**Pamela Ritchie:** We went through some of the discussion of cyclicals and defences broadly right off the top when you had a couple of comments about the markets, but maybe in addition to that, what parts of the market, or certain industries, are you seeing valuations that are just too expensive relative to your process, from the way that you're looking at things? Some of it might be what we discussed but just maybe reiterate that.

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**Ramona Persaud:** Where valuations have expanded … so the whole market looks expensive, which is always tricky. That's why you're seeing, what you're seeing lately is a market that's down. But inside of that, there's this big rotation back from value to growth. So interestingly, the value parts of the market are not as valued as they were certainly a year ago and definitely 15, 16 months ago. So financials are kind of middling in valuation, whereas they were pretty cheap before. Consumer discretionary, lots of that has gotten expensive to me. Let's see, staples are sort of cheap. Industrials have always been tricky on valuation because the margins look very peakish, and so you have to make some assumptions about margins, figure out a valuation [indecipherable]. Industrials are less cheap now. So those are the areas I've been drawing back.

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The areas I've been adding to are the more defensive, so health care's gotten a lot cheaper because it underperformed a lot during this value rally. Staples did as well. So I've been adding to those. What's interesting is in adding to those, because those are typically very good dividend payers, in adding to those, I boost the yield by adding to defensives. So that's helpful as well. So those types of yields have gotten cheaper.

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**Pamela Ritchie:** So interesting. Now we're going to bounce back to ESG, just to go back into this area generally. Just again, go into the depth of ... you're working with a group of analysts and where they're going with things. There are a lot of people that see ESG as a bit of a flag for some version of greenwashing, of some version of trying to make it fit too neatly. Does that raise flags for you? How do you handle that? And again, how do you sort of put it into your own process?

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**Ramona Persaud:** Really good question. The way I think about ESG is, one, it's good when capital deployed in industry is helpful for the world and not harmful. That's kind of like a basic premise for me. And I think many people, but maybe not everyone knows, maybe that premise comes from the fact that my formative training is in environmental science and engineering. So I care about the state of the environment, certainly. So that's a basic premise. The way that I then go from there is, if I'm going to be sensitive to ESG, I don't want it to compromise alpha because alpha is sort of the fiduciary responsibility of, as stated, of the portfolios. So thankfully, the data supports that ESG does not compromise alpha, especially when you go either towards the best ESG companies historically or the best disclosure ESG companies, which is not necessarily the best companies. Those two sort of factors, if you will, have produced good alpha historically.

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That might be an issue from this point forward because valuations of those two groups are at peak, which is why I'm doing it a little bit differently. So those are my two or three ESG premises. The way that ESG has naturally manifested in my funds, my funds tend to score better than the benchmark on ESG as driven mainly by the governance side, and that's because I tend to favour quality. But also on the E and the S, I tend to be either equal weight or overweight those factors over time versus my benchmarks. And I think that's because one) G is embedded in our investing culture at Fidelity. We like companies that are high quality, companies that are focused on all stakeholders, companies that are focused certainly on shareholders, companies that do the right thing. So that tends to be a core value at Fidelity.

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And then in the E and the S, the E I think is from my formative training. I've always been interested in how my companies are approaching the environment. From day one, when I became an analyst, I would ask them about their practices on the E, and then I think the S is intrinsic because I have a lot of experience with underrepresentation. So that's something that's always on my mind. When I see a company that's therefore taking an all-inclusive or an all-stakeholders approach to the way they run their business, that just resonates with me. So that's showing up in my process very naturally, such that the funds overweight the bench on ESG. I am really delighted now that we have research, internal research that's focused on this because all of a sudden, I don't have to rely on scoring systems which are very, very flawed.

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So it's exciting to be able to again, use the research as a guided missile. Nicole Connolly has done an incredible job as the head of ESG, just building this discipline and continuing to really strengthen it at Fidelity for us to be able to figure out that maybe Suncor, at the margin, could be a better ESG investment than, say, Microsoft. Just making that up as an example, because Microsoft is well understood, but Suncor might not be. And that sort of premise is so exciting to me in terms of what research can do to invest in a really important space without compromising alpha.

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**Pamela Ritchie:** Absolutely fascinating. Ramona Persaud, it is always too short the time we have together. Thank you for spending your time with us.

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**Ramona Persaud:** My pleasure. Thank you too.

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